

issues requiring a investigation and, as a protection for ratepayers, suspension of the increases until that investigation is completed or for the statutory period of five months.

5. Below-band filings

305. The *Second Further Notice* proposed that tariffs decreasing rates by more than 5 percent adjusted for changes in the PCI would be filed on 45 days' notice, and would be accompanied by a showing that the rates cover the costs of providing service and are otherwise just, reasonable, and nondiscriminatory.⁴⁰¹ The Commission suggested that the average variable cost standard adopted for AT&T should also be used as the standard by which to determine whether LEC proposed rates were predatorily low.⁴⁰² This proposal stimulated much comment, with views ranging from those opposing any restriction on rate decreases to those asserting that additional restrictions are necessary, or that below-band filings should face traditional, rate of return regulation.

306. The LECs are divided in opinion on this proposal. Some offer qualified support.⁴⁰³ LEC opponents of our below-band proposal assert that no restrictions on downward price movements are necessary. They state that if there were an increase in the PCI, our proposed below-band standards would effectively raise the limit of the lower band, thereby driving rates which were previously just inside the lower limit down below it.⁴⁰⁴ Two LECs argue that there should be no lower band restriction at all.⁴⁰⁵

307. Other opponents of the proposed treatment of below-band tariffs state that it is based on the erroneous assumption that keeping prices above average variable cost will eliminate the possibility of predatory pricing.⁴⁰⁶ This may be true in a competitive market, these commenters suggest, but given LEC monopoly power, a more conservative approach is warranted.⁴⁰⁷

308. Other parties assert that the LECs are in effect demanding streamlined review for all rate reductions, regardless of magnitude, for the purpose of engaging in predatory pricing. They believe that the adoption of an average variable cost standard as the basis for permitting below-band rates will remove the last vestige of protection against anticompetitive behavior by the LECs.⁴⁰⁸ One commenter concludes that we should continue to subject below-band rate reductions to traditional tariff review, including the cost support requirements of Section 61.38 of our Rules.⁴⁰⁹

309. We believe that rate reductions are generally beneficial to consumers and, more often than not, are undertaken for competitive reasons. Predatory pricing, though often alleged, is fairly uncommon, and proven cases are rare.⁴¹⁰ Further, our LEC service basket structure lessens the already unlikely occurrence of predation. We are convinced that below-band reductions introduced under our price cap system will be more pro-competitive than predatory; nonetheless, we have decided to err on the side of caution and not accord below-band filings streamlined tariff review. Therefore, we seek a standard which requires suspension only of those rates which are so low that they can be presumed to be anticompetitive.

310. We believe that average variable cost provides just such a standard. While disagreement exists on the point at which prices can be presumed legal, and on the role of intent in finding antitrust violations,⁴¹¹ the question

whether prices are below marginal cost, or its surrogate, average variable cost, is central to the determination of whether prices are predatory. In adopting average variable cost as a tariff review standard, we do not find that all rates which cover average variable cost are necessarily just, reasonable, and non-discriminatory. Petitioners may be able to show that there is reason to investigate a rate decrease which we permit to go into effect after 45 days. Competitors can also file complaints alleging predatory pricing. In either case, it might be possible to show that the resulting rate is above average variable cost but nonetheless predatory using relevant antitrust analysis and precedent.

311. We accordingly direct all LECs seeking to introduce below-band rate reductions to file their transmittals on 45 days' notice. Below-band rate filings must be accompanied by a showing that the rates cover the cost of service and are otherwise just, reasonable, and non-discriminatory. In reviewing these tariffs, we will employ the average variable cost standard to determine whether a below-band reduction should be suspended pending investigation.

6. New and restructured services

312. In the *Second Further Notice* the Commission proposed to distinguish between new and restructured services and to treat them as they are treated under AT&T's price cap plan.⁴¹² Some parts of the proposal drew little comment (e.g., definitions) while others stimulated a large response. Below, we define new services as any that enlarge the range of service offerings available to customers (i.e., all existing offerings remain available). We define restructured services as any that modify a method of charging or provisioning a service that does not result in a net increase of service options available to customers. We also decide that new services will not be incorporated into the price cap system immediately, but will be included in the LEC's cap in the first annual price cap tariff filing after the completion of the base year in which the new service becomes effective. Finally, we conclude that restructured services will be filed on 45 days' notice and must demonstrate compliance with the price cap and banding limits of the basket to which they belong.

a. Definitions

313. The proposal to distinguish between new and restructured services in a manner identical to the treatment of new and restructured services offered by AT&T under price caps drew little comment.⁴¹³ Some of the comments relating to the proposed definitions concern matters not directly related to price cap regulation.⁴¹⁴

314. New and restructured services, because they present different issues, must undergo separate forms of regulatory analysis. It is important, therefore, to set a standard for distinguishing these services from one another. We will consider as new, services which add to the range of options already available to customers. A new service may, but need not, include a new technology or functional capability. Many new services are, in essence, re-priced versions of already-existing services. It is indeed rare for a carrier to offer a wholly different form of telecommunications service. As long as the pre-existing service is still offered, and the range of alternatives available to consumers is increased, we will classify the service as new. Restructured services, on the other hand, involve the rearrangement of existing services. Carriers can

Atlantic's suggestion that we defer consideration of this rule to our pending Part 65 proceeding. The termination of rate of return regulation for price cap carriers requires that we make provision for possible overearnings in the final enforcement period leading to price cap regulation. We also reject US West's suggestion regarding cash refunds because we believe that prospective PCI adjustments are simpler for us to monitor, easier for the affected LECs to implement, and considerably limit the potential for discrimination among ratepayers.³⁶⁶ In addition, we reject the suggestion of US West that this Commission lacks authority to order refunds except where a carrier has proposed a rate increase and an accounting order has been entered.³⁶⁷ We wish to make clear, as we have in earlier proceedings, that our refund authority under Section 204 is not limited to such cases,³⁶⁸ and that our refund authority extends beyond Section 204.³⁶⁹

V. LEGAL AUTHORITY

401. In adopting price cap regulation for AT&T, the Commission explained in detail the legal basis for its action.³⁷⁰ We concluded, *inter alia*, that: (1) substitution of price cap regulation for traditional rate of return regulation was within our authority under the Communications Act; (2) price cap regulation would comply with the Act's requirement that rates be just, reasonable, and non-discriminatory; (3) our no-suspension zone approach to price cap regulation was consistent with the Act and relevant judicial authority; (4) a rate prescription was not required in connection with our use of existing rates; and (5) a *de facto* rate prescription had not been undertaken in connection with or no suspension zone approach to price caps. Consistent with our tentative conclusion in the *Second Further Notice* that price cap regulation of local exchange carriers is lawful,³⁷¹ we conclude, for the reasons set forth there and supplemented below, that the LEC price cap plan adopted today is within our legal authority under the Act, and that it will assure that LEC interstate rates remain just, reasonable, and non-discriminatory.

402. The primary basis for this conclusion is that our price cap plan for the LECs largely tracks our AT&T price cap plan. Both plans feature a streamlined tariff review process with suspension and no-suspension zones, baskets, service categories, and bands to guard against precipitous price changes for particular services, as well as a price cap formula that is based on existing rates,³⁷² reflects cost changes and includes a Consumer Productivity Dividend that requires carriers to increase their productivity above historical levels to take advantage of the increased flexibility provided by the price cap system. Several parties repeat legal arguments previously rejected in the context of the AT&T plan, but they do not explain why our legal conclusions in that context were wrong or are not directly applicable to price caps for LECs.³⁷³ Accordingly, we again reject those arguments for the reasons set forth in the *AT&T Price Cap Order*.

403. Compared with the price cap plan we adopted for AT&T, we have added one additional safeguard to our LEC plan to respond to the concern that, as discussed previously,³⁷⁴ we may not be able to select a productivity figure for the LECs in which we have precisely the same high degree of confidence as we have in the productivity figure chosen for AT&T. As a result of this concern, there is some risk that relying solely on the approach taken in

the AT&T plan could result in a particular LEC earning increased profits that are not necessarily tied to increases in productivity. Accordingly, we have adopted a sharing mechanism, described in detail above, for carriers that comply with price cap ceilings.³⁷⁵ By setting an upper limit on LEC profits and adding an additional mechanism to ensure that ratepayers directly benefit from any increases in profits,³⁷⁶ we are further ensuring that LEC rates will remain within a zone of reasonableness.

404. We adopt the sharing mechanism pursuant to our general Rule Making authority contained in Sections 4(i) and 201-203 of the Act as well as our prescription authority contained in Section 205 of the Act.³⁷⁷ In addition to the sharing mechanism, and under the same authority, we have included in our LEC price cap plan a lower end adjustment mechanism consistent with our obligation to ensure that LEC rates are not confiscatory.³⁷⁸

405. We disagree with those who argue that our price cap plan fails to assure just and reasonable rates because it does not adequately take carrier costs and profits into account.³⁷⁹ As we have explained, price cap rates do reflect costs and take profits into account, albeit in a different manner than do rate of return rates.³⁸⁰ Our decision to modify the manner in which we take costs and profits into account is based on our analysis that the price cap cost benchmark will produce efficiencies unattainable in the prior regulatory system, and is fully supported by relevant precedent.³⁸¹ Furthermore, the relative absence of competition compared to the interexchange market is not a legal basis to block price cap reform for LECs, as some have claimed.³⁸² Price cap regulation for AT&T was not predicated on the existence of competition, and nothing in the design of LEC price cap regulation is predicated on the existence of competition for interstate access services. In fact, the absence of competition is one reason we decided to employ the backstop of a sharing mechanism to prevent even the possibility of excessive monopoly earnings.³⁸³

406. With respect to costs and profits, we will continue to rely, as we do with AT&T, on the Section 204 investigation and Section 208 complaint processes as part of our plan to ensure just, reasonable, and non-discriminatory rates.³⁸⁴ In light of our selection of the sharing and adjustment mechanisms, complaints claiming that overall company earnings that comply with the sharing mechanism are excessive in view of costs will not lie. Since our sharing mechanism does not relate to specific rates, however, complaints that particular rates are unjust and unreasonable in light of the relevant costs and profits, or that they are discriminatory, may continue to be filed. In addition, if a LEC does not appear to be in compliance with the sharing mechanism, its tariffs would be subject to investigation and suspension pending an inquiry into the extent to which its price cap indexes had been sufficiently reduced to properly account for its historical earnings. Complaints could also be filed in this case. Similarly, if a LEC has been permitted to charge above-cap rates, the sharing mechanisms would no longer apply, and the LEC's rates would be subject to complaint on the basis that they are unjust and unreasonable in light of the current rate of return prescription. Thus, our investigation and complaint processes will remain important tools in ensuring just, reasonable, and non-discriminatory rates, and in monitoring carrier costs and profits.

ATTACHMENT B

PRICE CAP PERFORMANCE REVIEW FOR LOCAL EXCHANGE CARRIERS CC Docket No. 94-1

Comments of May 9, 1994

Pacific Bell and Nevada Bell
Pages 9-12

Bell Atlantic
Pages ii-iii, 9, 12-13

Affidavit of Alfred E. Kahn
Pages 10-12

U S WEST
Pages 16, 20

Ameritech
Pages 12-14

Reply Comments of June 29, 1994

Bell Atlantic
Pages 9, 12, 15

Affidavit of Dr. James H. Vander Weide
Pages 9-10 & 16-17

U S WEST
Pages 20-21

Pacific Bell and Nevada Bell
Pages 2-3 and 13-14

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of)

Price Cap Performance Review for)
Local Exchange Carriers)

CC Docket No. 94-1

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III. BASELINE ISSUES: REVISE THE PRICE CAP RULES FOR EXISTING SERVICES THAT ARE NOT FULLY COMPETITIVE.

The Commission also seeks comment on the following "Baseline Issues." Notice, para. 36.

A. Universal Service and the NII.

Baseline Issue 1a: Whether, and if so how, the Commission should revise the LEC price cap plan to support the development of a ubiquitous national information infrastructure (NII).

The best and lowest-risk approach to building the NII would be simply to remove the present disincentives to doing so. These disincentives include the sharing mechanism (which taxes the returns on any investment in the network, and makes other investments seem artificially more attractive); arbitrary reductions to revenues (such as the current productivity factor), which reduce internally generated funds that could be used to make productivity-enhancing investments; and restrictions on pricing flexibility and new service offerings, which penalize consumers and retard innovation and responsiveness.

We believe the biggest disincentive to building the NII lies in the backstop mechanisms. They confer artificial advantages and disadvantages on the current providers: we suffer from earnings limitations our competitors don't have, which increases our cost of competing. Our competitors don't have the assurance of the LFAM, which increases their business risk relative to ours. While leveling the playing field to put us and our competitors on the same footing, eliminating the backstop

mechanisms would also remove a great disincentive to efficiency and investment.

Earnings limitations discourage investments in the American network of the future by expressly limiting the potential return to investors. The potential telecommunications investor will compare the returns on regulated services in America to unregulated services, as well as the returns available in America (where earnings are limited by the price cap rules) to the returns available elsewhere (such as Japan, Germany, or the U.K., where earnings are essentially unlimited). It takes little financial acumen to realize that investing in the regulated services of the LECs will probably not produce the greater return.

In earlier decades it might have been said that the low return realized by the LEC investor was commensurate with low risk. That's no longer the case. Investors perceive our level of risk to have risen (see below, p. 39). They expect a commensurate return -- a return which, with sharing limitations, is difficult to provide them no matter how efficient we become. It should come as no surprise if investors see more risk in our business than the Commission does. Investors focus on future returns, not past returns. They know that even greater competition will develop tomorrow. From their point of view, waiting for some ideal degree of competition to "develop" before making substantial changes to the rules would be closing the barn

door after the horses have fled. The investment dollars will already have flowed elsewhere.¹⁰

Sharing also detracts from consumer welfare by giving some providers -- those who share in our earnings but don't have to share theirs, who benefit from asymmetrical regulation vis-a-vis the LECs, and who are free to discriminate and to enter and exit markets at will -- financial and marketing advantages over us that have nothing to do with greater efficiency or responsiveness to customers.

Building the NII is good business as well as good public policy. We have many competitors who'd like to build it before we do. They'll argue that our ability and incentive to invest in our networks needs to be constrained. For our competitors, sharing kills two birds with one stone: we are further constrained from building the NII; they build it with our revenues. Consumers are harmed when regulators create artificial advantages and disadvantages for competitors. Inefficient providers are encouraged to enter markets, and consumers as a whole pay higher prices. Regulatory oversight will remain appropriate for the shrinking number of monopoly services. But "managed competition" generally harms consumers more than it helps them.

In return for an end to sharing, we are willing to forego the assurance of the LFAM and many exogenous cost adjustments. After all, we believe that a good regulatory plan

¹⁰ See Darby Associates, "Price Cap Reform, Financial Incentives and LEC Investment," filed with USTA's Comments in this docket.

is one that recognizes the increasing riskiness of investment decisions; protects customers from the risk of investments that may turn out to be uneconomic or unsuccessful; and provides shareholders new incentives to attract sufficient investment in the public telephone network. To meet those objectives, the plan must also shift the risk of poor investment decisions and the rewards of good investment decisions to shareholders. The LFAM should not be eliminated unless sharing is also eliminated: the increase in our downside risk must be balanced with an increase in potential returns, or investors will take their money elsewhere.

Originally, the Commission adopted the backstop mechanisms because it was concerned that the uniform nationwide productivity factor it selected for price cap LECs would not be "perfectly accurate."¹¹ If that factor was too low, sharing would offset it; if it was too high, the LFAM would remedy it. Although studies have not borne out the Commission's original concern -- they show the productivity factor was, if anything, too high¹² -- we believe there is an independent, critical reason to eliminate the backstop mechanisms: they are a deterrent to making the investments needed to build the NII.

¹¹ Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd. 6786, para. 120 (1990).

¹² See L. R. Christensen, P. E. Schoech, and M. E. Weitzen, "Productivity of the Local Operating Telephone Companies Subject to Price Cap Regulation," filed with USTA's Comments in this docket.

Before The
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of

Price Cap Performance Review
for Local Exchange Carriers

Notice of Proposed Rulemaking

CC Docket 94-1

May 9 '94

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regulation is always a second best alternative to competition, it nonetheless is critical to duplicate the incentives and benefits of a competitive market to the fullest extent possible. With a plethora of alternative investment opportunities available, LECs need the incentives that a competitive market would provide to make economically efficient investments in an advanced infrastructure. And with competitive pressures steadily increasing, LECs need the flexibility to compete on even terms and to introduce new and innovative services. Only then will they be able to deliver the full benefits of the information age to consumers.

The current price cap plan does not provide these same benefits. The current plan retains vestiges of rate of return regulation that present all the pitfalls of a cost plus system of government contracting. It blunts efficiency incentives and forestalls economically efficient investment. The current plan also incorporates intrusive and redundant regulatory controls that deny LECs the flexibility they need to compete and inhibit the introduction of innovative new services. Ironically, the most competitive services are subject to the most extensive constraints. As a result, it denies consumers the benefits that would result from a system that accurately duplicates the incentives of a competitive market.

The solution to these problems is four-fold. First, remaining elements of rate of return regulation must be eliminated. This means abolishing the sharing and lower-bound



adjustment mechanisms, and permitting LECs to adopt market driven depreciation practices. This will give LECs the incentives to make economically efficient investments, while placing the risk of these investments squarely on the shoulders of shareholders. It is the same approach the Commission has already adopted both for AT&T and for the cable TV companies.

Second, the productivity offset must be brought into line with the average productivity differential historically experienced by the industry. As demonstrated by a direct measure of LEC total factor productivity growth in the period since divestiture, the current offset is roughly double historical experience. The year-over-year price reductions required by this offset have forced LECs to aggressively cut costs in an effort to keep pace. During the initial period of price cap regulation, LECs did so by squeezing out inefficiencies during the transition from rate of return regulation. This resulted in the loss of thousands of jobs. But by the end of four full years of price cap regulation, these inefficiencies will have been wrung out. The same rate of cost reductions cannot be sustained in the future, and the artificially high productivity differential in the current plan cannot be achieved over the long term. On the contrary, LEC productivity growth will likely decline in the years ahead as competition intensifies and business is lost to other providers.

Third, the Commission should remove competitive, new and discretionary services from rate and price regulation. This

is in line with the risk involved.²⁴ The result will be to promote infrastructure investment to the ultimate benefit of consumers, and to produce economic development and growth.²⁵ And by eliminating the lower-bound adjustment, a pure price cap plan will place the risk of this investment squarely on the backs of shareholders.²⁶

Second, adopting a pure price cap plan removes any conceivable reason for maintaining an archaic three year depreciation prescription process that artificially inflates LEC earnings, and unnecessarily burdens the Commission and LECs alike.²⁷ By producing artificially long depreciation schedules that are out of touch with the marketplace, this process also adds to the disincentive created by sharing to undertake new investment.²⁸ As a result, LECs should be allowed to propose

²⁴ In contrast, a sharing mechanism acts as a brake on LECs' incentives to undertake this investment by arbitrarily limiting the return that can be earned in exchange for taking this risk. See Harris Study at 20. Sharing also limits the ability of LECs to raise the capital needed to fund these investments, since LECs must compete for capital with unregulated firms and other regulated firms such as cable and AT&T that are not limited so. Like rate of return regulation, sharing encourages LECs to invest where they do not face the same constraints, whether overseas or in unregulated areas.

²⁵ Harris Aff. at 20-21; WEFA Study at 1-2.

²⁶ Harris Study at 20-21.

²⁷ The Commission previously declined to permit LECs to propose their own depreciation rates, but recognized that a different result may be appropriate once sharing is eliminated. Simplification of the Depreciation Prescription Process, 8 FCC Rcd 8052, ¶ 43 (1993).

²⁸ Harris Study at 21-23.

LECs the regulatory certainty they need to make long term investment decisions.³⁶

B. The Commission Should Reject Attempts To
Other Aspects Of Rate Of Return Regulation

The Commission also should reject attempts to
other aspects of rate of return regulation.

In particular, including a one-time price adjustment examination of LEC earnings as part of the current review is inappropriate.³⁷ Any action based on LEC costs or earnings would destroy the very incentives that price caps seek to create. The message to LECs would be that unsuccessful efforts to innovate and become more efficient will be rewarded with higher rates, while successful efforts will be punished by lower rates. In short, this effectively means a full scale reversion to rate of return regulation and all the harmful incentives it creates.

³⁶ Harris Study at 30-31. Certainty in the regulatory environment is critical to LECs and their competitors as they are to accept the significant market risk involved in investing in advanced infrastructures. Id. It also is critical to provide the stability they need to pursue economic and other public policy initiatives, for example by funding to ensure that schools and classrooms are connected to advanced information infrastructure.

³⁷ See NPRM at ¶ 46.

³⁸ Harris Study at 30-31; NERA, Economic Performance of the LEC Price Cap Plan at 25-28 (submitted in support of this proceeding) ("NERA Study").

Likewise, adjusting prices for changes in interest rates would be a step backward toward cost of service regulation, and should be rejected out of hand.³⁹ Moreover, such an adjustment would serve no purpose. The inflation adjustment and productivity offset already serve to adjust for overall cost changes on an ongoing basis, including interest costs.⁴⁰ As a result, the effect of adding a separate ongoing adjustment factor for interest costs would be to double count these costs, and to skew the efficiency incentives from price caps.⁴¹

C. The Commission Should Adopt A Corrected Productivity Offset

The productivity offset of 3.3 percent included in the current plan substantially exceeds the productivity gains historically experienced by the industry.⁴² The year-over-year

³⁹ NERA Study at 25-28.

⁴⁰ Id.

⁴¹ Id. In contrast to an ongoing adjustment, a one time adjustment would unfairly reward or penalize LEC's by locking in interest rates at a single point in time. Interest rates are cyclical, as the recent upturn in rates demonstrates. Vogel, "Investors Are Shrouded in Interest-Rate Gloom: Jobs Report Seen Prompting New Fed Action," The Wall Street Journal at C1 (May 9, 1994). Locking in current rates would unfairly penalize LECs as rates increase in the future.

⁴² The current offset is composed of two parts: An estimate of historical LEC productivity growth of 2.8% and an added consumer dividend of .5%. The 2.8% historical estimate was based on a pair of studies, one long term and one short, that attempted to indirectly estimate LEC productivity based on incomplete data. LEC Price Cap Order at 67-98. Because the Commission concluded that neither of those particular studies was an adequate basis to set an offset, it selected a number at the midpoint of the range between the two estimates. Id.

Before The
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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In the Matter of)	
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Price Cap Performance Review)	
for Local Exchange Carriers)	CC Docket 94-1
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Notice of Proposed Rulemaking)	
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AFFIDAVIT OF ALFRED E. KAHN

I. BACKGROUND, QUALIFICATIONS AND SUMMARY

(1) My name is Alfred E. Kahn. I am the Robert Julius Thorne Professor of Political Economy, Emeritus, at Cornell University and Special Consultant to National Economic Research Associates, Inc. My business address is 308 North Cayuga Street, Ithaca, New York 14850.

(2) Among the experiences of mine most pertinent to my submission in this proceeding are that I was Chairman of the New York State Public Service Commission between 1974 and 1977 and of the Civil Aeronautics Board in 1977-78; I am the author of the two-volume The Economics of Regulation, published originally by John Wiley & Sons in 1970 and 1971 and reprinted in 1988 by The MIT Press; I have written and testified extensively on the subject of telecommunications regulatory policy and published a book and numerous articles on antitrust policy. I was a member of the Attorney General's National Committee to Study the Antitrust Laws and the National Commission for the

the complete transfer from ratepayers to shareholders of the risks and benefits of unsuccessful or successful performance. The longer the interval between reexaminations of the price caps and the wider the range of achieved rates of return that regulators, the utility companies and the public can tolerate, the closer will be the approximation to the workings of competition. The ultimate reform is, clearly, to sever the link between costs and rates and to subject the LECs to "pure" price caps, just as the Commission has already done in the case of AT&T and the cable industry.

(21) The extraordinarily great importance of innovation in telecommunications provides the strongest reasons for eliminating all vestiges of rate base/rate of return regulation. By narrowing the range of profits that companies may expect to obtain from such ventures--and, as part of the same process, by typically permitting the current recovery of depreciation at rates widely recognized as unrealistically low for industries subject to rapid technological change¹³--those remaining elements of rate of return regulation tend to inhibit the undertaking of risky innovations.¹⁴ This damping tendency is accentuated by the understandable reluctance of regulators fully to pass on to ratepayers the sometimes very large costs of ventures that turn out unsuccessfully. Those remaining elements therefore have a tendency not merely to narrow the range of expected profit outcomes but to do so asymmetrically--giving rise to an expectation that risk-taking companies may be denied the ability to recover the costs of unsuccessful ventures while being denied also the ability fully to retain the offsetting profits of successful ones.

(22) The competitive ideal is that risks of innovative ventures be borne not by ratepayers but by investors. In this model, ratepayers are not required to bear the losses stemming from unsuccessful investments; by the same token, neither are they permitted to appropriate the profits stemming from successful ones. The converse of this proposition

¹³See Kahn *The Economics of Regulation*, Vol. 1, pp. 117-122, "Depreciation Policy and Technological Progress," and Vol. 2, pp. 146-47, 149-50.

¹⁴I observed this tendency more than 20 years ago, while at the same time offering the opinion that its practical effect was probably slight. *Ibid.*, Vol. 1, pp. 53-54. This was however before some of the large write-offs of the 1980s. See also Crandall, *After the Breakup: U.S. Telecommunications in a More Competitive Era*, Washington, DC: Brookings Institution, 1991, Chapter 3.

is of course that if the risks are to be borne by the investors, they must see the opportunity of retaining the supernormal profits from successful ventures.

(23) We have in the last very few years experienced a growing public recognition of the very large benefits to the economy at large of encouraging major investments by the telephone companies in what it is now a cliché to refer to as information superhighways--requiring very large investments in the digitalization of their networks and conversion to fiber optic transmission--while avoiding the imposition of unreasonable burdens on the subscribers to basic service. These investments--and the public's attitude toward them--have several characteristics arguing strongly for taking them fully out from under any remaining elements of traditional rate base/rate of return regulation. First, they are very large and very risky: their profitability will depend heavily on their ability to deliver new, diversified services the demand for which is highly uncertain and the offer of which may well be highly competitive. Second, despite the widespread conception that a modern electronic highway is likely to have very large external benefits to society at large--in terms of reducing congestion, saving transportation costs, permitting the superior delivery of such heavily publicly-funded services as education and health care and contributing powerfully to the increase of productivity and international competitiveness--there is a great reluctance to expend large sums of public money on their development. This is so not only because of the ubiquitous constraints on government budgets but also because of the inevitable uncertainty, in an environment of constantly changing technology, about the wisdom of particular investment programs. The third factor is the preoccupation of public policy makers with keeping the price of basic telephone service low and affordable, so as not to jeopardize the universality of subscription to it, and so with not permitting these investments to impose a burden on basic rates.

(24) These considerations lend added weight to the reform of the present LEC price cap plan that I have already recommended--substitution of a pure price cap on services for which competition has not fully developed and that we are determined to keep affordable, regardless of what happens to overall company costs and revenues. Such an arrangement has the virtue not only of protecting purchasers of the latter services from the outcomes of these huge new investments and the profitability or unprofitability of the services that they promise to be able to deliver; it also has the at least equal virtue of

placing on the shareholders of the private companies the responsibility and the risks of the major new investments required, along with the undiluted incentive to assume those risks because they will profit fully and without dilution to the extent the investments prove successful.

(25) Pure price cap regulation has the additional great virtue of making it possible to relax the restrictions on the ability of utility companies to compete and so mitigates the distortions of competition that those restrictions entail. Under rate of return regulation--and, to a lesser extent, under price cap schemes that retain elements of rate of return--there is always at least a theoretical possibility that the utility company, having reduced the prices of its competitive services, may be able to return to the regulator and obtain the right to raise prices of its less competitive services, in order to enable it to earn at the authorized level overall. This danger in turn provides the rationale for regulators setting floors under the competitive prices, with the enthusiastic support of the utility companies' rivals, floors typically above incremental cost--in order to make a "fair contribution" to the company's overall revenue requirements--and therefore at potentially inefficiently high levels.

(26) This is not to deny the possibility that unregulated companies as well may engage in predatory pricing. What makes no sense in unregulated markets, however--and also makes no sense under pure price caps--is cross-subsidization: there is no reason for unregulated firms not to have set the prices of their less competitive services at profit-maximizing levels already and firms subject to pure price caps not to have set them at the most profitable level permitted by the caps. In both situations this leaves no opportunity for recoupment of net revenue losses flowing from predation. We do not in unregulated markets guard against possible predation by setting floors under the prices of competitive services: it is widely recognized that such a practice would be far more likely to suppress competition, on balance, than to protect it. It is only the presence of rate base/rate of return regulation that creates the possibility of recoupment and therefore of cross-subsidization.

(27) The obvious solution to the problem of potential cross-subsidization, therefore, is not to put floors under the prices or otherwise hamstring the telephone companies in competitive markets but to abandon any remaining elements of rate base/rate

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554**

In the Matter of

**Price Cap Performance Review
for Local Exchange Carriers**

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CC Docket No. 94-1

COMMENTS

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May 9, 1994

and Associates³⁸ indicates the differential since divestiture between LEC productivity gains and those of U.S. industry as a whole has been only 1.7 percent.³⁹ While the Christensen study more accurately reflects LECs' experience since divestiture, use of this lower productivity factor in the price cap plan might also provide a rationalization for continued use of a sharing adjustment in the LEC price cap plan to guard against the possibility of a LEC windfall. As such, U S WEST believes the better course of action is to leave the productivity factor unchanged and eliminate sharing -- despite the fact that LECs will find it more difficult to achieve the same level of productivity gains with increasing competition.⁴⁰

U S WEST opposes any adjustment to the price cap formula or price cap rates to reflect changes in interest rates or the cost of capital. Any such adjustments would undercut price cap regulation and be a step backward toward rate of return

³⁸See USTA Comments at Attachment 4, "Productivity of the Local Telephone Operating Companies" by Lauritis R. Christensen, Phillip E. Schoech and Mark E. Meitzen ("TFP Study").

³⁹The fact that U S WEST does not object to use of a 3.3 percent productivity offset in the interstate price cap plan does not imply that it is appropriate to use this level for adjusting intrastate (i.e., local exchange) rates in any intrastate price cap plan.

⁴⁰The greatest opportunities for productivity gains are in the most dense markets (e.g., central business districts in large cities). New methods and cost-saving technologies can be introduced in these areas at a much lower per-unit cost than in less dense markets. However, the most dense areas are also the most attractive to competitors and the most likely areas for LECs to experience competitive losses. As customers in high density areas are lost to competitors, the average density of LEC traffic and services will decline. Consequently, LECs will have greater difficulty in achieving the same level of productivity gains than they did in the past.

D. ~~Term~~

Another critical factor in determining LEC incentives and potential efficiency gains under a price cap plan is the length of the plan. This assumes, of course, that the price cap plan is stable -- remains unchanged -- during the term of the plan. SPR's research and the work of others⁴⁸ indicate that efficiency incentives rise significantly as the length of term or review period is increased.⁴⁹ However, as with everything else in life, there is a trade-off for greater potential efficiency. That is, the longer the length of the plan, the greater the risk of uncertainty. The Commission's goal should be to balance this risk against potential gains in efficiency in selecting the length of time before the next price cap review. SPR suggests that the review period should be 8-10 years for a pure price cap plan.⁵⁰

While there may have been good reason to establish a conservative or relatively short review period at the commencement of price cap regulation, this justification no longer exists after three full years of experience. U S WEST believes that if the Commission adopts a price cap plan which accommodates competition, eliminates sharing and streamlines the introduction of new services, the plan should remain in place for

⁴⁸See Paul R. Joskow and Richard Schmalensee, Incentive Regulation for Electric Utilities, Yale J. on Reg., Fall 1986, at 25.

⁴⁹SPR Study at 16-24.

⁵⁰Id. at 20, citing to Richard Schmalensee, Good Reporting Regimes, RAND J. of Econ., Autumn 1989, at 417-35.

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554**

In the Matter of)	
Price Cap Performance Review)	CC Docket No. 94-1
for Local Exchange Carriers)	

COMMENTS OF AMERITECH

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Dated: May 9, 1994

Assuming that the productivity offset factor was set correctly in the first instance – i.e., that it was a reasonable estimate of what, in a cost-of-service regulation environment, would have been the LECs' productivity performance differential versus the economy as a whole – then there is no reason for the productivity factor to be adjusted. Rates under price cap regulation are reasonable because the price cap formula precludes them from being higher in the aggregate than they would have been under the prior regulatory scheme. Moreover, the formula guarantees customers rate decreases in real terms. Every year, prices are capped at a level that declines relative to inflation. In return, carriers are given the incentive to become more efficient than they would have under cost of service regulation.

Certainly, it would be totally inappropriate and inconsistent for the Commission to seek to increase the price cap plan's productivity offset or to require a one-time adjustment to the LECs' price cap index in light of perceived LEC productivity increases. The Commission set the price cap plan's 2.8% base productivity offset figure as a reasonable estimate of what price cap LECs' productivity performance would have been under rate of return regulation. Assuming, for argument sake, that LEC productivity performance has increased under price caps, it is more likely than not to have been the result of the incentive aspects of price cap regulation itself. To require a give-back of those productivity gains either via a one-time (permanent) reduction to the LECs' price caps or by an increased productivity offset (whose effect is compounded) would impose retroactively the very disincentives to efficiency associated with cost of service regulation that price caps was supposed to correct. Certainly, if a LEC believes that any efficiency improvements will ultimately have to be given back, its inclination to engage significant resources in improvement efforts will be

correspondingly reduced. The result would be a significant dilution, if not an out-right eradication, of the efficiency incentives of price cap regulation.

Further, the Commission has asked whether it should adopt a mechanism to adjust the plan to reflect changes in interest rates. The answer is that the Commission already has a mechanism that adjusts the plan to reflect those changes – it is called the GNPPI. Interest is a cost of doing business for all firms in the economy. As costs change, firms adjust their prices. Those price changes are reflected in the GNPPI. Interest rate changes are similar to corporate tax rate changes. Even though the LECs cannot control interest rates or tax rates, interest and corporate taxes are a normal risk of doing business facing all firms in the economy. Since the Commission considers corporate tax rate changes as endogenous, interest rate changes should also be considered endogenous. An automatic adjustment to the price cap index is not needed for future changes in interest rates since those interest rate changes will be reflected in the GNPPI. Also, a one-time reduction due to the past interest rate changes is not appropriate since those interest rate changes have already been reflected in the GNPPI. Thus, no additional modifications of the price cap formula need be made for changes in interest rates.

Baseline Issue 3c: The reasonableness of price cap LECs' profit levels.

Yes, price caps LECs' profit levels are reasonable. Moreover, in comparison to the rest of the market, LEC regulated earnings are artificially inflated by arbitrarily low depreciation rates. By way of example, if Ameritech's interstate earnings were restated using the composite depreciation rate of 10.3% used by AT&T in 1992, Ameritech's rate of return would be about 400 basis points lower than the return that was based on its mandated lower depreciation rates and reported on Form 492A. And, in any event, higher profit levels are

exactly what the price cap plan anticipated. On the other side of the coin, customers have benefited from the rate reductions effected by the plan; and it is the rates customers ultimately care about – not LEC profit levels. Thus, there should be no modifications of the plan to adjust for any variations in LEC profit levels from those prevailing at the plan's inception.

D. Sharing And Low-End Adjustment Mechanisms

Baseline Issue 4a: Whether the sharing and low-end adjustment mechanisms should be realigned with capital costs.

Baseline Issue 4b: Whether the sharing and low-end adjustment mechanisms should be revised or eliminated.

Clearly, the sharing mechanism should be eliminated as being inconsistent with the incentive intent of the price cap plan. Its residual earnings regulation character is a throw back to the prior regulatory regime and constitutes a significant mitigation of the efficiency incentive aspects of the Commission's price cap plan. Any price cap carrier's enthusiasm for a significant efficiency enhancing undertaking will be cooled by the knowledge that a substantial portion of the benefits of that initiative will not be able to be retained. Moreover, the regulation of carrier earnings is not necessary to ensure just and reasonable rates. Rates that comply with the price cap formula are reasonable because they have been kept in line relative to inflation – and in fact have been forced to decline in real terms – by the price cap formula itself.

The original reason for including a sharing/automatic stabilizer mechanism as part of the LECs' price cap plan was a concern that the industry-wide productivity offset figure of 2.8% might constitute a significant